How Gas Taxes Work

Most states levy a fixed-rate gas tax that collects a specific number of cents in tax on every gallon of gas purchased. In Texas, for example, drivers have been paying exactly twenty cents per gallon in state gas taxes for over two decades. Thirty-two states have gas taxes designed entirely around this type of fixed-rate structure. Among the other eighteen states, fifteen tax gasoline based on its price—much like the traditional sales taxes that most states levy on things like furniture, toothpaste, and televisions. Since gas prices tend to grow over time, the tax paid on a gallon of gas grows as well. These types of gas taxes are therefore called variable-rate taxes. Two states, Florida and Massachusetts, levy a slightly different type of variable-rate gas tax—one that grows alongside a broader measure of inflation in the economy, rather than alongside the price of gas. Maryland’s gas tax is a hybrid of these two approaches.

A Vital Transportation Revenue Source

State gas taxes are the single most important source of transportation revenue under the control of state lawmakers. Roughly 30 percent of state own-source highway funding comes from state gas taxes. Many states use gas tax revenues for mass transit projects as well, under the sensible assumption that highway users benefit from the congestion-reducing effects of transit. But while gas taxes remain a vital transportation revenue source today, their relative contribution to state transportation budgets is actually declining. Taxes and fees paid by drivers (the most significant of which is the gas tax) now make up a smaller share of total highway funding than at any point since the Interstate Highway System was created in 1957. But this shift in transportation finance did not come about because of a conscious change in policy. Instead, it is due to flaws in the design of the gas tax that have left it incapable of handling the challenges outlined below.

Challenges Confronting State Gas Taxes

State gas taxes, as currently designed, are an unsustainable revenue source. This means that over time, the revenue generated by state gas taxes tends to fall increasingly short of meeting state infrastructure needs. The most unsustainable type of gas tax is the fixed-rate tax, where the tax rate remains unchanged year after year. But even variable-rate gas taxes are sometimes unable to generate an adequate amount of revenue over time. The reason behind the unsustainability in state gas taxes is twofold.

First, vehicle fuel efficiency has been on the rise since 2004. While improving fuel efficiency is no doubt a positive development overall, it also creates an undeniable problem for the gas tax. As efficiency has improved, drivers are now able to travel further distances on each tank of gas before they have to stop, refuel, and pay anything in gas taxes. Those extra miles being squeezed out of each tank of gas are essentially tax-free, relative to what drivers had been paying previously.

The second challenge confronting state gas taxes is the rising cost of building and maintaining the nation’s transportation infrastructure. While fuel efficiency improvements directly reduce the amount of revenue raised by gas taxes, the rising cost of construction puts additional strain on whatever revenue is being raised. Since 1990, transportation construction costs have risen by 63 percent, meaning that a construction project that previously cost $50,000 would now cost over $80,000 to complete. But while the costs of asphalt, concrete, and machinery grow almost constantly, most state gas taxes are rarely increased.

Twenty-four states have gone more than a decade without raising their gas tax rate, and sixteen states have gone two decades or more without an increase. Lawmakers worried about the political ramifications of “raising taxes” are kicking the proverbial can down the crumbling road, even if the
so-called “tax increase” under consideration is simply an attempt to address
the inevitable shortfall created by rising costs and improving fuel efficiency.

Consequences of Inaction

When viewed as a percentage of families’ household budgets, state gas
taxes are lower than at any point since the widespread adoption of those
taxes at the end of the 1920’s. Focusing on the more recent past, ITEP
found that state gas tax rates, adjusted for construction cost inflation, are a
full 17 percent lower today than they were in 1990. That’s the equivalent of
a 5 cent gas tax cut on every gallon purchased—though in some states the
decline has been significantly larger.

The decline of the gas tax is costing states significant revenue. If every
state had reformed its gas tax to grow alongside construction costs the last
time lawmakers raised the tax, the states as a whole would be bringing in
more than $10 billion in additional gas tax revenue every year. Some states,
such as New Jersey and Tennessee, would each be bringing in more than
$500 million in additional annual revenue.

These revenue losses have been a major factor in the worsening
condition of the nation’s infrastructure. According to the American Society
of Civil Engineers (ASCE), a quarter of America’s bridges are structurally
deficient or obsolete, one-third of the nation’s major roads are in poor or
mediocre condition, almost half of all major urban highways are congested,
and nearly half of all Americans lack access to bus or rail transit. As a
result of these deficiencies, the ASCE estimates that Americans waste the
monetary equivalent of $32 billion in travel time delays each year, and
another $97 billion on vehicle operating costs. Given all these problems, it
should come as little surprise that even business leaders—a group hardly
enamored with taxes—oft en come down on the side of raising state gas
taxes in order to fund a more effi   cient transportation system.

When gas taxes are allowed to stagnate, the consequences are not always
limited to state transportation systems. Recently, a number of states have
enacted long-term raids on their general funds, where a certain percentage
of tax revenue usually reserved for education, human services, and other
public priorities is siphoned off to make up for lagging gas tax revenues.
Some lawmakers have pointed out the problems with this approach, but far
too many view a general fund Band-Aid as an easy way to delay politically
difficult, but long-overdue reforms to the gas tax.

Recommendations for Reform

Despite the dismal condition of so many state gas taxes, there are a few
straightforward reforms that states can use to fi x these broken, but vital,
revenue sources:

• Rising fuel efficiency and construction costs have significantly reduced
  the purchasing power of state gas taxes. The fi rst and most obvious step
  that states should take to offset these declines is to increase their gas
tax rates.

• An increase in state gas taxes, however necessary, will be of little help
  in the long-term unless steps are taken to ensure that the tax can
  withstand future increases in fuel efficiency and construction costs.

Restructuring state gas tax rates so that they grow over time
can help alleviate this problem. Restructuring can come in a variety of
forms, including linking state gas tax rates to construction cost inflation,
the general infl ation rate, or gas prices.

• Like most taxes on consumption, state gas taxes are inevitably
  regressive—impacting low-income families far more heavily than any
  other group. The impact of gas taxes on families struggling to make ends
  meet is oft en cited in opposition to state gas taxes, but lawmakers can
  provide meaningful relief to these families via targeted low-income
tax credits, without having to starve states’ transportation revenue
streams.

Recent Progress

These recommendations are thoroughly tested and growing in popularity.
Lawmakers in seven states with diverse political climates have increased
and/or reformed their gas taxes since February 2013 (those states are
Maryland, Massachusetts, New Hampshire, Pennsylvania, Vermont,
Virginia, and Wyoming). As a result of these reforms, a majority of the
country’s population now lives in a state with a variable-rate gas tax that can
gradually grow alongside infl ation or gas prices. More states are poised to
consider adopting this approach in the years ahead.

Additional ITEP resources on this topic include:

• Building a Better Gas Tax (December 2011)
• How Long Has it Been Since Your State Raised Its Gas Tax?
  (April 2014)
• Most Americans Live in States with Variable-Rate Gas Taxes
  (April 2014)
• Don’t Blame the Gas Tax for High Gas Prices (May 2013)